

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
SAM I. AND MARJORIE H. LEWIS ) No. 80R-71-PD

Appearances:

For Appellants: Charles J. Jamison  
Attorney at Law

For Respondent: Carl G. Knopke .  
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a), 17 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Sam I. and Marjorie H. Lewis for refund of personal income tax and penalties in the total amount of **\$60,749.41** for the year 1977.

17 Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

Appeal of Sam I. and Marjorie H. Lewis

The primary issue is whether appellants properly amended their 1977 return to reclassify dividend distributions as loan repayments.

On March 20, 1973, Sam I. Lewis (herein referred to individually as the appellant) and Franke Thomas incorporated Palomar Electronics, **Inc.**, (herein Palomar). The corporation was to engage in the manufacture, importation, and sale of radio communication equipment, principally 23-channel CB equipment and 10 meter band amplifiers. Initial capitalization was \$30,000. Additionally, appellant loaned Palomar **\$240,674.68**, and Franke Thomas loaned it **\$210,589.34**. For federal tax **purposes**, Palomar elected subchapter S status; it selected the accrual method of accounting; and it adopted a taxable year which ended March 31. Appellants Sam I. and Marjorie H. Lewis were both on a taxable year which ended December 31. Both Palomar and appellants relied on the same certified public accountant for financial and tax advice.

For Palomar's fiscal year ended March 31, 1975, its books of account showed taxable income of **\$750,267.63**. Following the advice of its accountant, Palomar declared the entire amount as dividends. Appellant received **\$500,178.42**, and Franke Thomas received the balance. No funds were credited to the shareholders as repayment of the **loans previously** made by them to the corporation. At the end of the 1975 income year, appellant purchased the entire interest and assumed the debts and receivables of Franke Thomas in Palomar. Appellant's son then purchased five percent **of Palomar's** shares leaving appellant with ninety-five percent of its shares.

During the income year ended March 31, 1976, Palomar advanced \$188,327 to appellant. For that year, Palomar calculated its taxable income at **\$1,756,998.91**. Once again, on the advice of its accountant, the entire amount was declared as dividends, and appellant was credited with **\$1,683,793.55** of that amount. The amount in his "Advance" account was closed to the "Earned Surplus" account and thus reclassified as a dividend. On June 15, 1976, Palomar issued appellant a check for **\$1,495,466.55**, representing the balance of dividends due. As in the previous year, no amount was set aside or applied to the reduction of appellant's loan made on incorporation.

Appellant placed the dividend check in his personal account. However, since Palomar did not have

Appeal of Sam I. and Marjorie H. Lewis

the funds available to pay the check because of a slow **conversion of** inventory and receivables into cash, it borrowed \$1,500,000, to be repaid in one (1) year, from the First National Bank of San Diego. The bank required appellant to guarantee the loan by pledging the account in which he had deposited the corporation's dividend check. At this time, Palomar had not repaid appellants' incorporation loan or any of the loan from Franke Thomas to Palomar, which had been assigned to appellant. The total amount of these loans was approximately \$392,000. (Apps. Op. Br. at 4.)

In June 1976, the Federal Communications Commission (**F.C.C.**) issued an order banning the manufacture, importation and sale, after January 1, 1977, of **23-channel** citizen's band **radios**, Palomar's major product. The F.C.C. also implemented a government-financed advertising campaign aimed at dissuading the public from purchasing 23-channel units and encouraging them to buy **40-channel** units after January 1, 1977. As a result, a major portion of Palomar's inventory became obsolete, and sales dropped drastically. When sales were made, they were usually at a price far below Palomar's cost. By March 31, 1977, Palomar had a large stock of allegedly useless raw materials and electronic components. Because of spreading bankruptcies in the industry, 60 percent of its accounts receivable were more than 120 days past due. Despite the reverses, neither that inventory nor those receivables were marked down to reflect any decrease in value.

During the income year ended March 31, 1977, Palomar advanced \$621,650 to Mr. Lewis so that he could pay his personal tax liability for 1975 and make estimated tax payments for 1976. These **amounts were** charged to the "Advance" account. At the **termination** of its income year ended March 31, 1977, Palomar calculated its income to be **\$1,200,743.29**, which placed appellant's 95 percent equity interest in that income at **\$1,140,706.11**. Again, on the advice of its accountant, the entire amount was declared **as dividends**.

On April 1, 1977, the day after the dividend declaration, Palomar issued its check to First National Bank of San Diego **for \$1,500,083.33** in repayment of the bank's loan of June 1976. Palomar had no cash to cover this check. The same day, appellant advanced **\$1,500,000** to the corporation from his account which he had previously pledged to guarantee the First National loan.

Appeal of Sam I. and Marjorie H. Lewis

On June 15, 1977, Palomar issued its check to appellant for **\$519,066.11**, which represented the balance of the dividends due him after offsetting his share of Palomar's taxable income with advances previously made to him of \$622,650. The offset previously had been recorded on Palomar's books on March 31, 1977. Again, Palomar was short of cash. In order to pay this **check**, appellant loaned Palomar \$600,000 by using the proceeds of the dividend check plus some additional funds of his own. The net result was that during the calendar year 1977, Mr. Lewis loaned Palomar **\$2,100,000** and received distributions of **\$1,140,706.11** which were classified as dividends. Palomar continued to owe Mr. Lewis more than \$300,000 for incorporation loans.

Palomar's prospects were further dimmed in mid-1977 when it became aware that the F.C.C. was considering a proposal to ban the sale of amplifiers operating on the lo-meter band, the other major product line of the company.

In April, 1978, the F.C.C. banned amplifiers operating on the lo-meter band, which rendered obsolete materials and components on hand valued at more than \$500,000. During this time, Mr. Lewis was seriously ill. Because of his long-standing relationship with Mr. Lewis and the company tasks imposed on him, the accountant continued to exercise great influence on the financial operations of the company. Despite the reverses and problems described above, neither inventory nor receivables were marked down.

Appellants timely filed their 1977 personal income tax return, prepared by their accountant, showing **\$1,140,706** in dividends received from Palomar and a self-determined tax liability of \$149,074. But appellants remitted only \$33,000 with the return.. Respondent issued a notice and demand for the amount of the reported but unpaid tax as well as penalties for failure to pay the tax and failure to pay the estimated tax.

The fortunes of Palomar Electronics continued to decline. In 1979, Palomar attempted to obtain a loan from First National Bank to meet operating expenses. In order to improve the financial posture of the company, Mr. Lewis agreed with the bank to consider all previous dividend payments as repayments of his loans to the company. Despite Mr. Lewis' actions, Palomar failed to overcome its financial difficulties. Eventually,

Appeal of Sam I. and Marjorie H. Lewis

Palomar's affairs were turned over to the San Diego Wholesale Credit Association.

In 1979, appellants filed an amended return reclassifying the dividends as loan repayments and also making adjustments to interest previously reported. The total decrease in reported income was **\$1,158,020**. Respondent treated the amended return as a claim for refund and commenced an audit. Of the **\$1,140,706** in dividend income originally reported by appellants, respondent allowed a partial reclassification of \$519,056, which represented the balance of 1977 dividends which were paid to Mr. Lewis by check on June 15, 1977.<sup>2/</sup> Respondent also discovered unreported rental income of \$5,767 and allowed a partial reduction of interest income in the amount of \$7,452. These audit changes served only to lower the amounts of unpaid taxes and penalty which respondent determined were due from appellants. Accordingly, respondent denied appellants' claim for refund.

Appellants appeal the denial of the claim for refund and also seek relief from penalties assessed for failure to pay the tax by the due date and for underpayment of estimated taxes.

It is settled law that respondent's determinations of additional tax due are presumptively correct, and the burden rests upon the taxpayer to prove them erroneous. (Todd v. McColgan, 89 Cal.App.2d 509 [201 P.2d 414] (1949); Appeal of Ottar G. Balle, Cal. St. Bd. of Equal., Feb. 6, 1980; Appeal of Myron E. and Alice 2. Gire, Cal. St. Bd. of Equal., Sept. 10, 1969,)

The thrust of appellants' argument is that inept accounting **caused** the corporation's books to show "earnings and profits" which did not exist. Then, in the mistaken belief that immediate distribution of those "earnings and profits" as dividends was necessary to avoid the possibility of future burdensome taxation, the corporation's directors distributed those illusory

<sup>2/</sup> Apparently, respondent reclassified the balance of the dividends because that amount was paid on June 15, 1977, after the appellant had advanced Palomar **\$1,500,000** on April 1, 1977. Since appellants' claim for refund is concerned with the income represented by Palomar's payments which respondent did not reclassify, the characterization of the payments which respondent did reclassify is not before this board.

Appeal of Sam I. and Marjorie H. Lewis

profits as cash dividends notwithstanding the fact that the corporation had no "earnings and profits" and that the distributions were in violation of the restrictions on dividends imposed by section 500 of the Corporations Code when considered in the light of the true financial situation of Palomar. Accordingly, the corporation's \$621,650 distributed to appellants should be classified as loan repayments because dividend payments would not have been permitted by section 500 of the Corporations Code.

We believe appellants' argument is without merit. Initially, we note that appellants' reliance on the California Corporations Code is misplaced since a corporate distribution may be a dividend for tax purposes even though it is unlawful under state law. (See generally, Bittker and **Eustice**, Federal Income Taxation of Corporations and Shareholders, ¶ 7.02 (4th ed. 1979); cf. United States v. Lesoine, 203 F.2d 123, 126 (9th Cir. 1953).) A corporate distribution **is** a dividend that must be included in the recipient's gross income if, and to the extent that, it came out of earnings and profits of the corporation accumulated after February 28, 1913 or out of earnings and profits of the taxable year. (See Rev. & Tax. Code, §§ 17321, 17323(a), and 17381.) To the extent that a distribution by a corporation is not covered by current or post-1913 earnings and profits, it is treated as a return of capital to the shareholder, to be applied against the adjusted basis of his stock. (See Rev. & Tax. Code, § 17323(b).) If the distribution exceeds the adjusted basis of the stock, the excess is generally taxed as capital gain. (See Rev. & Tax. Code, - § 17323(c)(1).)

Respondent has effectively accepted appellants' theory that the corporation had neither current nor accumulated earnings **and** profits for **the** year in which the distributions were made. As a **result**, respondent **also determined that the distribution made by the corporation to its shareholders in the prior year had reduced the basis in appellants' stock to zero.** Therefore, respondent has concluded that the distributions involved in this appeal are properly taxable as a capital gain from the sale or exchange of property and not as ordinary income. (Rev. & Tax. Code, § 17323(c)(1).) Since the corporation was formed in 1973 and appellants bought out the remaining shareholders in 1975, the capital gain was from property held for more than one year but less than five years. Consequently, respondent concluded that only 65 percent of the gain is subject to taxation. (Rev. &

Appeal of Sam I. and Marjorie H. Lewis

Tax. Code, § 18162.5(a)(2).) Respondent has agreed to make the necessary adjustments to reflect this change.

Appellants also contend that the \$621,650 distribution was a repayment of the **\$302,630.02** balance remaining on the incorporation's loans. The short answer to this contention is that there is nothing in the record that even suggests that such action was intended by either the corporation or appellants. There is no rule which forbids treating corporate distributions as dividends merely because the stockholder may also be a corporate creditor. (Levy v. Commissioner, 30 T.C. 1315, 1327 (1958).) Under the circumstances, we conclude that appellants have failed to satisfy their burden of proof that the corporate distribution was intended to extinguish the prior incorporation indebtedness. While not controlling, it is interesting to note that, with respect to the incorporation loan, appellant has presented no note, payment schedule, or any other evidence that a valid indebtedness, as opposed to an additional capital contribution, even existed.

Appellants also attempt to protest the penalties imposed for failure to pay tax by the due date (Rev. & Tax. Code, § 18684.2) and for underpayment of estimated tax (Rev. & Tax. Code, § 18685.05). Respondent contends that this board does not have jurisdiction to consider the applicability of these penalties which became due and payable upon respondent's notice and demand but which have not been paid.

This board's powers to hear appeals from the respondent's actions in administering the Personal Income Tax Law are created solely by the Personal Income Tax Law. For instance, section 18595 empowers this board to hear and determine appeals from respondent's notice of action contemplated by section 18593 on a taxpayer's protest of its proposed deficiency assessments. In this case, respondent has issued no deficiency assessment; it has issued its notice and demand under section 18684.2. Respondent's action under section 18684.2 is not an action which the Personal Income Tax Law permits a taxpayer to appeal to this board. If the penalty is paid, appellants can file a claim for refund and, if their claim is denied, they may appeal to this board from respondent's denial of the claim. (Cf. Appeal of General Telephone Company of California, Cal. St. Bd. of Equal., Sept. 27, 1978.)

Appeal of Sam L. and Marjorie H. Lewis

For the reasons set forth above, **respondent's**  
action must be sustained as modified by its **concession.**



Appeal of Sam I. and Marjorie H. Lewis

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Sam I. and Marjorie-H. Lewis for refund of personal income tax and penalties in the total amount **of \$60,749.41** for the year 1977, be and the same is hereby modified in accordance with respondent's concession. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 3rd day Of December , 1985, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Nevins, and Mr. Harvey present..

|                  |            |
|------------------|------------|
| _____            | , Chairman |
| Conway H. Collis | , Member   |
| Richard Nevins   | , Member   |
| Walter Harvey*   | , Member   |
| _____            | , Member   |

\*For Kenneth Cory, per Government Code section 7.9